

# City and County of San Francisco

Office of the Controller - City Services Auditor

## BOARD OF SUPERVISORS:

A Review of Comcast of California III,  
Inc.'s Franchise Fee Payments 2003  
Through 2005

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**CITY AND COUNTY OF SAN FRANCISCO**  
**OFFICE OF THE CONTROLLER**

**Ed Harrington**  
**Controller**

**Monique Zmuda**  
**Deputy Controller**

April 2, 2007

Audit Number 05040

Board of Supervisors  
City Hall, Room 244  
1 Dr. Carlton B. Goodlett Place  
San Francisco, CA 94102

President and Members:

The Office of the Controller (Controller) presents its report concerning the review of the franchise fee payments Comcast of California III, Inc. (Comcast) made to the City and County of San Francisco (City) to operate a cable television system. Comcast is required to report its gross revenues from the operation of the system each quarter and to pay five percent of the gross revenues as a franchise fee to the City. Comcast is also required to pay cash grants for facilities and the support of public, educational, and governmental channels.

**Reporting Period:** January 1, 2003, through December 31, 2005

|                  |                |                  |
|------------------|----------------|------------------|
| <b>Payments:</b> | Franchise Fees | \$19,517,819     |
|                  | Grants         | <u>1,622,500</u> |
|                  | Total          | \$21,140,319     |

**Results:**

Comcast correctly paid, in all material respects, the franchise fees and cash grant due to the City on a timely basis. However, the City has not yet resolved several issues we identified in our 2004 audit regarding additional amounts that Comcast may be required to pay.

The responses of the Department of Telecommunications and Information Services (department) and Comcast are attached to this report. The Controller's City Services Auditor-Financial Audits will be working with the department to follow up on the status of the recommendations made in the report.

Respectfully submitted,

Ed Harrington  
Controller



## BACKGROUND

Comcast of California III, Inc. (Comcast) operates a cable television system for residents of the City and County of San Francisco (City). The City's cable television franchise ordinance<sup>1</sup> (franchise agreement) requires Comcast to report its gross revenues from the operation of the cable television system each quarter and to pay five percent of the gross revenues as a franchise fee to the City within 90 days after the end of each quarter. The franchise agreement defines gross revenues as payments or other consideration that Comcast received in connection with providing cable service in the city. Comcast's revenues include various subscriber fees, such as fees for basic cable services, and pay per view, as well as revenues from shopping channel commissions and advertising sales. The franchise agreement also requires Comcast to make grant payments to the City for facilities and the support of public, educational, and governmental channels.

Under Chapter 11 of the San Francisco Administrative Code, the Department of Telecommunications and Information Services (department) administers the cable system franchise.

## SCOPE AND METHODOLOGY

The purpose of this audit was to determine whether Comcast correctly reported its gross revenues and correctly paid the City the franchise fees and grants due from January 1, 2003, through December 31, 2005. To determine whether Comcast correctly reported gross revenues, we tested on a sample basis Comcast's supporting records. We also assessed the timeliness of Comcast's franchise fee payments. As part of our review, we interviewed staff from Comcast, the department, and the Office of the City Attorney.

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<sup>1</sup> Ordinance No. 105-64 as amended by Ordinance Nos. 226-99 and 237-05

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## AUDIT RESULTS

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### COMCAST CORRECTLY PAID ITS FRANCHISE FEES AND GRANTS

From January 1, 2003, through December 31, 2005, Comcast of California III, Inc. reported earning \$390,356,384 in gross revenues and correctly paid, in all material respects, \$19,517,819 in franchise fees to the City on a timely basis. The table below shows the reported gross revenues and franchise fees paid to the City for the three years. Comcast also correctly paid \$1,622,500 in cash grants for facilities and the support of public, educational, and governmental channels as required under its franchise agreement.

TABLE

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**Reported Gross Revenues and Franchise Fees Paid  
January 1, 2003, Through December 31, 2005**

| <b>Year</b> | <b>Reported<br/>Gross Revenues</b> | <b>Franchise<br/>Fees Paid</b> |
|-------------|------------------------------------|--------------------------------|
| 2003        | \$118,339,575                      | \$5,916,979                    |
| 2004        | 129,733,928                        | 6,486,696                      |
| 2005        | 142,282,881                        | 7,114,144                      |
| Total       | \$390,356,384                      | \$19,517,819                   |

### **Some Franchise Agreement Provisions Still Need Clarification**

Comcast still does not report some revenue sources that could be considered reportable gross revenues, and therefore subject to the City's franchise fee. We identified these issues in our audit of Comcast in 2004 and recommended that the Department of Telecommunications and Information Services resolve these issues with Comcast. However, the department has not yet secured Comcast's agreement to do so.

### ***Definition of Gross Revenues Not Precise***

The franchise agreement defines gross revenues as all cash, payments, or other consideration of any kind that Comcast receives in connection with providing cable service in the City, and specifies a list of some revenue sources. This broad definition does not provide sufficient guidance to determine whether Comcast properly excluded launch fees from its gross revenues. According to Comcast, some new networks pay a lump-sum

launch fee to offset Comcast's programming cost of including the network in the cable line-up, such as advertising costs to promote the new networks' programs. Comcast's view is that generally accepted accounting principles allow it to treat these fees as a reduction of its programming costs, and not as gross revenues. Nevertheless, since launch fees are payments Comcast received for providing cable services, such fees may be interpreted to represent gross revenues subject to City's franchise fee.

### ***Advertising Commissions***

Comcast excludes commissions it paid to advertising agencies from the advertising revenues it reports to the City as part of the gross revenues. While the franchise agreement allows Comcast to do so, the agreement also names the specific advertising agency to which this provision applies. Since Comcast no longer does business with the agency, the franchise agreement needs to be clarified whether Comcast is allowed to report only net advertising revenues from other advertising agencies. Although Comcast's procedures appeared to result in Comcast reporting to the City the amount of revenues intended by the agreement, Comcast should have obtained the City's approval for the reporting changes.

### ***Value of Promotional Free Services***

Comcast does not include the fair market value of promotional free services in the gross revenue it reports to the City. For example, Comcast may provide customers one month of free basic cable services, free installation of cable services, or two months of a free premium channel. Section 32.12 of the franchise agreement defines gross revenue as including the fair market value of any free services, except for the fair market value of any free services provided to the grantee's employees, to public buildings, or to non-profit organizations.

Comcast does not believe that promotional free services provided to customers fall within the definition of gross receipts subject to the franchise fee. Comcast further asserts that paying franchise fees on these services would cause it to pay more than the franchise limit of five percent of gross revenues.

While we are not presently contesting Comcast's treatment of these revenue items, the City reserves the right to pursue them in the future.



## RECOMMENDATIONS

To ensure that Comcast of California III, Inc. pays all of the franchise fees that are due, the Department of Telecommunications and Information Services should take the following actions:

- Negotiate with Comcast a more precise definition of gross revenues that specifies revenue sources to be included or excluded from gross revenues. The definition should address whether launch fees are subject to franchise fees.
- Negotiate with Comcast to clarify whether Comcast should report only its net advertising revenues, which excludes the commissions it pays to advertising agencies.
- Determine whether it is valid for Comcast to exclude the fair market value of promotional free services from its reported gross revenues.

We conducted this audit according to the standards established by the Institute of Internal Auditors. We limited our audit to those areas specified in the audit scope section of this report.

Staff: Ben Carlick, Audit Manager  
Edwin De Jesus

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# DEPARTMENT OF TELECOMMUNICATIONS AND INFORMATION SERVICES RESPONSE TO THE AUDIT:

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CITY AND COUNTY OF SAN FRANCISCO



Chris Vein  
Chief Information Officer  
Telephone: (415) 554-0801

DEPARTMENT OF TELECOMMUNICATIONS  
AND INFORMATION SERVICES

Ron Vinson  
Chief Administrative Officer  
Telephone: (415) 554-0803

January 17, 2007

Edward Harrington, Controller  
Controller's Office  
City Hall, Room 316  
1 Dr. Carlton B. Goodlett Place  
San Francisco, CA 94102

Dear Mr. Harrington,

The Department of Telecommunications and Information Services (DTIS) has received Audit No. 05040, *Review of Comcast Corporation's Franchise Fee Payments 2003 Through 2005*. DTIS supports all of the proposed recommendations, and will undertake the following actions in response.

Based on the stated willingness of Comcast to address these issues, DTIS will seek to negotiate with Comcast to modify the franchise definition of gross revenues. In its letter dated December 8, 2006 (attached to the Audit), Comcast indicates its concurrence in the need to refine and update the definition of gross revenues under the franchise, specifically to clarify the status of launch fees, advertising agency commissions, and promotional free services. DTIS will enter into discussions with Comcast to over the coming months to seek modifications acceptable to both parties.

In addition, DTIS will continue to assess the effect of a new state franchising law (AB 2987), which may impose certain future restrictions on the definition of gross revenues for cable operators that apply for state-issued franchises. These state-imposed restrictions may limit our ability to secure the recommended changes to the gross revenues definition in future years.

Please do not hesitate to contact me if you have additional questions regarding this response.

Respectfully Yours,

A handwritten signature in dark ink, appearing to read "Ron Vinson", written over a horizontal line.

Ron Vinson

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# COMCAST OF CALIFORNIA III, INC.

## RESPONSE TO THE AUDIT:

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Comcast Cable  
193 Inverness Drive West  
Englewood, CO 80112

December 8, 2006

Edward Harrington, Controller  
Controller's Office  
City Hall, Room 316  
1 Dr. Carlton B. Goodlett Place  
San Francisco, CA 94102

Dear Mr. Harrington:

We have received your draft report, Audit Number 05040, for the franchise fees that Comcast of California III, Inc. paid to the City and County of San Francisco for January 1, 2003 through December 31, 2005. Comcast is satisfied no significant issues were found during the audit and that all payments, in all material respects, were determined to be paid in an accurate and timely manner. Following are Comcast responses to the recommendations proposed in the draft audit report.

### Recommendation #1

Negotiate with Comcast a more precise definition of gross revenues that specifies revenue sources to be included or excluded from gross revenues. The definition should address whether launch fees are subject to franchise fees.

### Response

Comcast concurs that a more updated and refined definition of gross revenues that specifies revenue sources to be included or excluded from gross revenue would be beneficial to both parties. We also agree it is important to have a formalized method to address unforeseen revenue sources and their inclusion or exclusion in gross revenues as the business continues to evolve.

### Recommendation #2

Negotiate with Comcast to clarify whether Comcast should report only its net advertising revenues, which excludes the commissions it pays to advertising agencies.

### Response

Again Comcast agrees that clarification of the defined gross revenues pertaining to the exclusion or inclusion of the commissions paid to advertising agencies with respect to advertising revenues would be beneficial to both parties' interests. Comcast would like to assure the City that we are committed to reporting advertising revenues in compliance with the franchise agreement. However, our contention is that cooperative advertising commissions do not constitute any portion of "gross revenues" and, therefore, are not subject to franchise fees.

December 8, 2006

Recommendation #3


Determine whether it is valid for Comcast to exclude the fair market value of promotional free services from its reported gross revenues.

Response

Comcast concurs any new agreement needs to address this issue. As stated in prior communication, Comcast asserts that it is not appropriate to include the fair market value of promotional free services in the definition of gross revenues.

Finally, we appreciate the good working relationship experienced throughout the audit with Ben Carlick, Audit Manager and Edwin De Jesus. They demonstrated professionalism and objectivity throughout the engagement.

Sincerely,



Jan F. Stenzel  
Accounting Manager, West Division

cc: Mayor  
Board of Supervisors  
Civil Grand Jury  
Budget Analyst  
Public Library





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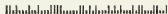


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